In the Supreme Court of the United States

OCTOBER TERM, 1968

No. 1281

MISSISSIPPI VALLEY PORTLAND CEMENT COMPANY,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The opinion of the district court (Pet. App. A16–A22) is reported at 280 F. Supp. 393 (S.D. Miss.). The opinion of the court of appeals (Pet. App. A23–A37) is not officially reported as of this time.

JURISDICTION

The judgment of the court of appeals was entered on March 14, 1969. (Pet. App. A38.) The petition for a writ of certiorari was filed on April 19, 1969. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

351-345—69

QUESTION PRESENTED

Whether petitioner, which manufactured and sold cement to the general public, was entitled to deduct distributions to its stockholders as "patronage dividends" under Section 1388 of the Internal Revenue Code of 1954 when it neither did business with nor made sales or purchases for them and when the stockholders did not participate in petitioner's operation.

STATUTES INVOLVED

Section 1382 (a) and (b) and 1388(a) of the Internal Revenue Code of 1954 set forth in pertinent part in the Appendix, *infra*, pp. 7–8.

STATEMENT

When petitioner was incorporated in Mississippi in 1956, it issued 500,000 shares of stock. Approximately 417,000 shares were issued to eight individuals, and the balance to friends, relatives and employees. In 1957 it sold an additional 1,400,000 shares to the general public. (Pet. App. A1–A3.)

Petitioner was organized as a cooperative under Mississippi law to manufacture and sell cement. Its charter, as amended, gives the record owner or assign of every five shares of stock a preferred patronage right to purchase one barrel of cement during each fiscal year. (Pet. App. A4–A7.) Pursuant to authority conferred upon it by the charter, the petitioner's board of directors, commencing in 1959, adopted resolutions in January of each year allocating the entire production of cement for its ensuing taxable year to the stockholder-patrons or their assigns on the basis of their stock ownership. Under the board resolutions

profits from the production of cement were to belong to the stockholder-patrons of record at the end of each fiscal year and either held in trust for their account or refunded as a patronage rebate in cash or reserve certificates. (Pet. App. A7–A10.)

The resolutions also provided that sales of cement would be made to or for the account of Valley Cement Sales, Inc., a separate corporation, which several of the petitioner's officers, directors and stockholders organized in January 1959 as a sales agency for the stockholder-patrons. Petitioner could sell or deliver to Valley any cement the stockholders or their assignees had not taken during the month following production. (Pet. App. A9–A12.)

During the taxable years involved—1962, 1963 and 1964—all of the cement petitioner produced was delivered to Valley Cement Sales for sale either in accordance with assignments of stockholders or in accordance with the board resolutions (Pet. App. A10–A11). At the conclusion of each tax year, the net receipts from sales of cement over and above production costs were allocated or distributed to the stockholders in proportion to each person's then stock ownership. (Pet. App. A11–A12.)

In its income tax returns for 1962, 1963, and 1964, petitioner deducted or excluded $285,215.14, $454,208.41, and $421,296.68, respectively, from its gross income as patronage dividends either allocated or paid to its stockholder-patrons[1] (Pet. App. A11). These

[1] The district court found that it was not shown that petitioner had any stockholders other than those designated by it as stockholder-patrons (Pet. App. A17).

amounts were the profits on cement Valley sold for the account of petitioner's stockholders. In result, petitioner reported no taxable income for these years. (Pet. App. A12.) The Commissioner of Internal Revenue disallowed the deductions and petitioner paid the resulting deficiency. In a suit for refund the district court upheld the Government's position that these amounts are not deductible from petitioner's income as "patronage dividends" paid to stockholders of a cooperative (Pet. App. A16–A22). The court of appeals affirmed (Pet. App. A38).

ARGUMENT

The decision below is correct. There is no conflict or other reason for further review.

1. Petitioner, a publicly-held stock corporation, produced cement at a profit derived solely from sales to the general public. Petitioner's claim that it need not pay corporate income taxes on these earnings is grounded on the theory that under state law it was bound to give over to its stockholders all the income earned from the sales of cement. But it is axiomatic that federal and not state law determines what constitutes income for federal tax purposes. *Burnet* v. *Harmel,* 287 U.S. 103, 110; *Lyeth* v. *Hoey,* 305 U.S. 188. Under basic federal income tax principles, corporate earnings are taxed first to the corporation when earned and then to the shareholders when distributed. It matters not that the charter or resolution of the Directors or anything else requires all or some fixed amount of the corporate earnings to be paid out as dividends. Were this not so, any corporation could

insulate all or part of its earnings from tax by providing that a fixed percentage of earnings shall be distributed annually.

This case indeed fits within the established principle that compensation is taxed to the earner, despite anticipatory arrangements designed to prevent the vesting of such compensation in the one who earned it. *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260; *Helvering* v. *Horst*, 311 U.S. 112; see, also, *Lucas* v. *Earl*, 281 U.S. 111, 114–115; *Moline Properties* v. *Commissioner*, 319 U.S. 436. Consonant with these authorities the courts below properly held that petitioner's charter provision, which merely assigned petitioner's right to receive the profits to its stockholders, and did not relieve petitioner of its liability for federal income taxes.

2. Petitioner is not, as it contends (Pet. 12–13), entitled to a deduction for patronage dividends under Sections 1382 and 1388(a) of the Internal Revenue Code of 1954, Appendix, *infra*, pp. 7–8. The essential point is that petitioner did not operate on a cooperative basis. A cooperative association is a business organization organized and operated by its members for their mutual benefit as patrons on the basis of the amount or value of their patronage or business done with the organization, and not for their benefit as investors on the basis of their investment in the company. Thus a cooperative may market the products of its patrons or provide them with needed goods or services at the lowest possible cost. See *Farmers Cooperative Co.* v. *Birmingham*, 86 F. Supp. 201 (N.D. Iowa). Not only must a cooperative remit its profits to its members, but its stockholders must be its pa-

trons. To the extent that the cooperative does business with non-shareholders, other than by selling products produced by its members, it is not being operated on a cooperative basis, and is not entitled to deduct the profits derived from such non-shareholder business. *Smith & Wiggins Gin, Inc.* v. *Commissioner,* 341 F. 2d 341 (C.A. 5); *Pomeroy Cooperative Grain Co.* v. *Commissioner,* 288 F. 2d 326 (C.A. 8).

Here, petitioner manufactured or produced cement, using its own plant and equipment and furnishing all materials and facilities. It caused the cement so produced or manufactured to be sold through Valley Cement Sales. During the years in question, its entire production of cement was delivered to Valley, which in turn sold the cement to members of the general public. Petitioner's stockholders neither purchased any of its cement nor participated in any manner in the production of the cement. The stockholders were merely investors, as in any ordinary business corporation. The courts below therefore were plainly right in holding that petitioner was not being operated on a cooperative basis.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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MAY 1969.

APPENDIX

SEC. 1382 [as added by Sec. 17(a), Revenue Act of 1962, P.L. 87–834, 76 Stat. 960]. TAXABLE INCOME OF COOPERATIVES.

(a) *Gross Income.*—Except as provided in subsection (b), the gross income of any organization to which this part applies shall be determined without any adjustment (as a reduction in gross receipts, an increase in cost of goods sold, or otherwise) by reason of any allocation or distribution to a patron out of the net earnings of such organization.

(b) *Patronage Dividends.*—In determining the taxable income of an organization to which this part applies, there shall not be taken into account amounts paid during the payment period for the taxable year—

(1) as patronage dividends (as defined in section 1388(a)), to the extent paid in money, qualified written notices of allocation (as defined in section 1388(c)), or other property (except nonqualified written notices of allocation as defined in section 1388(d)), with respect to patronage occurring during such taxable year; or

(2) in money or other property (except written notices of allocation) in redemption of a nonqualified written notice of allocation which was paid as a patronage dividend during the payment period for the taxable year during which the patronage occurred.

For purposes of this title, any amount not taken into account under the preceding sentence shall be treated

in the same manner as an item of gross income and as a deduction therefrom.

* * * * *

[26 U.S.C. 1382.]

SEC. 1388 [as added by Sec. 17(a), Revenue Act of 1962, P.L. 87-834, 76 Stat. 960]. DEFINITIONS; SPECIAL RULES.

(a) *Patronage Dividend.*—For purposes of this subchapter, the term "patronage dividend" means an amount paid to a patron by an organization to which part I of this subchapter applies—

(1) on the basis of quantity or value of business done with or for such patron,

(2) under an obligation of such organization to pay such amount, which obligation existed before the organization received the amount so paid, and

(3) which is determined by reference to the net earnings of the organization from business done with or for its patrons.

Such term does not include any amount paid to a patron to the extent that (A) such amount is out of earnings other than from business done with or for patrons, or (B) such amount is out of earnings from business done with or for other patrons to whom no amounts are paid, or to whom smaller amounts are paid, with respect to substantially identical transactions.

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[26 U.S.C. 1388.]

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